IN THE

Supreme Court of The United States

OCTOBER TERM, 1977

No. 77-648

FEDERAL ENERGY REGULATORY COMMISSION,

Petitioner,

v.

PENNZOIL PRODUCING COMPANY, ET AL.,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF OF RESPONDENT PENNZOIL PRODUCING COMPANY IN OPPOSITION

A. DUNCAN GRAY, JR.
Vice President and
General Attorney
Pennzoil Producing Company
3100 Pennzoil Place
Houston, Texas 77001

JERON STEVENS
STEPHEN M. HACKERMAN
Baker & Botts
3000 One Shell Plaza
Houston, Texas 77002
(713) 229-1234

Counsel For Respondent
Pennzoil Producing Company

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OPINIONS BELOW AND JURISDICTION

The opinions below are correctly referenced and the jurisdictional prerequisites are adequately set forth in the petition for a writ of certiorari.

QUESTION PRESENTED

Whether the Federal Energy Regulatory Commission (Commission) has the authority to adjust the rate charged

for the sale of natural gas by an independent gas producer to allow recovery of prudently incurred increased royalty costs based on prices in excess of Commission established ceiling rates.

STATUTES INVOLVED

Section 4(a) of the Natural Gas Act, 15 U.S.C. 717c(a), is correctly set forth in the petition for a writ of certiorari.

STATEMENT OF THE CASE

Pennzoil Producing Company (Pennzoil Producing) sells to United Gas Pipe Line Company gas produced from acreage in the Gibson Field, Terrebonne Parish, Louisiana, a portion of which is leased from Williams, Inc., *et al.* (Williams). Because the sale is in interstate commerce for resale, the price which Pennzoil Producing may collect is subject to the jurisdiction of the Commission and is limited to the applicable ceiling rates established by the Commission.[1] The amount that Williams, as lessor, receives from Pennzoil Producing in payment of royalties under the lease covering the acreage from which the gas is produced is not, however, subject to the Commission's jurisdiction. *Mobil Oil Corp.* v. *FPC,* 463 F.2d 256 (D.C. Cir. 1971), *cert. denied,* 406 U.S. 976 (1972).

The Williams lease provides for royalty payments based on one-eighth of the "market rate" of the gas. Pennzoil Producing is collecting the highest rates allowed by the Commission for the sale of the Williams acreage gas and is paying royalty based on such rates.[2] Williams claims, however, that the "market rate" for the gas is in excess of that which the Commission has determined to be the highest rate

[1] Natural Gas Act, Sections 1(b) and 4(a), 15 U.S.C. §§ 717(b) and 717c(a).

[2] A portion of the gas is covered by the rate set forth in 18 C.F.R. § 2.56b, adopted in FPC Opinion No. 749, and the rest is covered by the rate set forth in 18 C.F.R. § 2.56a, adopted in FPC Opinion Nos. 699-H and 770-A.

which Pennzoil Producing can collect. In a lawsuit pending in a Louisiana state court, Williams claims damages in excess of $3,000,000 for alleged past underpayment of royalties through April 20, 1975.[3] In addition, Williams asserts that the lease has terminated as a result of the alleged underpayment of royalties.

The parties to the Louisiana state court litigation reached a settlement agreement on June 18, 1975. Implementation of the agreement is dependent upon Commission authorization of one of two alternatives set forth in the agreement. First, the Williams litigation would be settled if the Commission authorized Pennzoil Producing to increase its rates for gas sold from the Gibson Field in an amount that would allow recovery of the increase in royalty payments that would be made under the settlement agreement. The royalty basis under the settlement agreement is a compromise figure. It is an amount in excess of the ceiling rates which Pennzoil believes to be the proper royalty basis, but less than the alleged market rate Williams asserts is the appropriate royalty basis. Contrary to the Commission's assertion that the settlement royalty basis is based on "market value," it is tied directly to Commission-set rates because it is a percentage of those rates and will change only as the rates set by the Commission change.[4] Thus the royalty

[3] *Shell Oil Co. and Pennzoil Producing Co.* v. *Williams Inc., et al.,* Civil District Court for Orleans Parish, Louisiana, Docket No. 573-591 (filed May 24, 1974). Shell Oil Company also owns an interest in the lease involved as well as an interest in another lease of which Williams is the lessor. Shell therefore is both a party to the Louisiana state court litigation and a respondent in this case.

[4] The royalty basis specified in the agreement is an amount equal to (1) the higher of 78¢ (plus 1.5¢ per Mcf annual escalations commencing January 1, 1976) or 150% of the highest area or national rate authorized by the Commission, plus (2) BTU and tax adjustment. The 78¢ was 150% of the then effective Commission-set national rate. The 150% figure was the same as that proposed by the Commission for small producers such as Williams appeared to be. Since the time this royalty basis was agreed upon, the Commission has adopted a new highest ceiling rate

increment will not, as the Commission suggests (Pet. 15), fluctuate along with intrastate prices — that simply is not a possibility raised by this case. Under the second alternative, the litigation would be settled if the Commission authorized Pennzoil Producing to abandon the sale of the royalty share of the gas so that Williams could take its royalty share in kind.

By its application below, Pennoil Producing sought the requisite Commission authorization. Because the price increase is totally based on increased royalty costs and will therefore generate absolutely no profit for Pennzoil Producing, and because this cost is a prudent and necessary expense, Pennzoil Producing believes the price increase to be just and reasonable. The Commission, however, rejected the price increase despite the evidentiary record showing it to be just and reasonable and in the public interest. Although "sympathetic to the plight of the producers who face . . . litigation on the value of royalties," the Commission nonetheless felt compelled to ignore the facts of record because of its view that, no matter whether prudently incurred and otherwise just and reasonable or not, the Commission is without authority to reflect in producer rates royalty costs based on prices in excess of ceiling rates.

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which became effective July 27, 1976. FPC Opin. No. 770-A (Nov. 5, 1976), *aff'd., The Second National Natural Gas Rate Cases,* F.2d (D.C. Cir. 1977), *petition for cert. filed,* U.S.L.W. (U.S. Nov. 15, 1977) (Nos. 77, 695, *et al.*). In addition, the small producer increment, which at the time the agreement was executed allowed small producers to collect 150% of the applicable ceiling rate, has been eliminated as to gas qualifying for the highest ceiling rate and set at 130% for other gas. Small Producer Regulation, Docket No. R-393, Opin. No. 742-B (Aug. 2, 1976) and Order No. 553-A (Sept. 9, 1976).

By letter of October 24, 1977, Williams agreed to modify the settlement royalty basis to take account of these changes in the Commission's pricing structure. As modified, the settlement royalty basis remains the same for gas delivered prior to July 27, 1976, but the royalty basis for gas delivered after July 26, 1976 will be the higher of (1) 78¢ as escalated or (2) 100% rather than 150% of the highest area or national rate.

The request to abandon the royalty share of the gas was presented to the Commission as an alternative to be considered only in the event the price increase request was denied. Pennzoil Producing believes the abandonment request is consistent with the public interest because, if the price increase request is denied, abandonment of the royalty share of the gas is the only means to settle the litigation and thereby eliminate the risk that all of the gas will be lost by the interstate market if Williams prevails as to lease termination. The Commission, however, denied the abandonment request based on its view, as expressed in the Commission's then unreviewed decision in the *Southland Royalty* case,[5] that the Williams acreage gas would have to be sold in interstate commerce even after termination of the Williams lease.

On appeal, the United States Court of Appeals for the Fifth Circuit determined that the Commission erred in rejecting both the alternative requests. Noting that Pennzoil Producing does not seek to increase its profits by the price increase, but instead merely seeks to recover incremental royalty costs, the Court held that the Commission has the authority to determine whether the incremental royalty cost is reasonable and, if so, to permit a price increase based on such cost. The Court viewed this Court's holding in *Mobil Oil Corp.* v. *FPC*, 417 U.S. 283 (1974), as affirming that authority. The Commission's rejection of the alternative abandonment request was reversed and remanded for further consideration because the Commission's *Southland Royalty* decision, upon which the Commission placed total reliance in rejecting the abandonment request, was itself reversed.[6]

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[5] *El Paso Natural Gas Co.*, Opin. No. 737, Docket No. CP75-209 (July 11, 1975) *reh'g. denied*, Opin. No. 737-A (Sept. 3, 1975).

[6] *Southland Royalty Co.* v. *FPC*, 543 F.2d 1134 (5th Cir. 1976), *cert. granted sub com. California* v. *Southland Royalty Co.*, 45 U.S.L.W. 3834 (June 27, 1977).

ARGUMENT

A writ of certiorari should not be granted in this case because the single question presented has already been answered by this Court. The question is whether the Commission has the authority to permit a producer to recover prudently incurred incremental royalty costs based on prices in excess of ceiling rates. This Court expressly answered that question in the affirmative in *Mobil Oil Corp.* v. *FPC,* 417 U.S. 283 (1974).

In addition to questioning its authority to consider the merits of the price increase request, the Commission in its petition also questions its authority to consider the merits of the alternative abandonment request. In fact, however, the Commission did not deny itself the authority to consider the merits of the abandonment request and thus its authority to grant that request is not an issue in this case. Consequently this case does not present any issue which justifies review by this Court.

I.

THE COMMISSION HAS THE AUTHORITY TO GRANT THE REQUESTED PRICE INCREASE

The authority to grant the price increase requested in this case is vested in the Commission by Section 4(a) of the Natural Gas Act. Under that Section, the Commission is authorized to permit a price increase so long as the increase is deemed to be "just and reasonable." The Commission now asserts that this same statute, which concededly requires it to assess the justness and reasonableness of the price increase, also denies it the authority to consider the facts bearing on that assessment. In its attempt to support this position, the Commission basically makes only two arguments. First, the Commission argues that *Mobil, supra,* merely recognizes that the Commission in fact has authority to grant relief in some instances where a cost component exceeds the Commission-established rate, but that such

recognition does not extend to royalty costs. Second, the Commission argues that *FPC* v. *Texaco,* 417 U.S. 380 (1974), prohibits approval of any rate (or component of a rate) which is equal to a market rate, regardless of any other facts or circumstances. Neither of those arguments has any basis.

As to the Commission's first argument, *Mobil* specifically addressed the issue of whether a producer faced with an incremental royalty cost may obtain relief from the Commission, and the answer was "Yes." In *Mobil,* this Court reviewed FPC Opinion No. 598 which established an area rate for Southern Louisiana. Mobil contended that the Opinion No. 598 rate was inadequate because the royalty component of the Opinion No. 598 rate was based entirely on the ceiling rate, while some producers faced the possibility of having to pay royalties on the basis of prices in excess of the ceiling rate.

In response, this Court held that the royalty component was adequate because not all producers faced the possibility of market value royalty costs and those who were subsequently put in a royalty bind could obtain relief through individualized proceedings. In so holding, this Court adopted the language that had been used by the Court of Appeals in responding to Mobil's contention:

> "If, as subsequent events develop, the producers are put in a bind by their royalty obligations, they may certainly petition FPC for individualized relief." 417 U.S. at 328 [quoting from *Placid Oil Corp.* v. *FPC,* 483 F.2d 880 (5th Cir. 1973)].

The Commission has attempted to deal with *Mobil,* but its attempts are successful only to show that the question presented in this case has already been answered in *Mobil.* Thus, the Commission stated on rehearing of Opinion No. 753 that *Mobil* indicates ". . . that relief on some grounds may be possible . . . ." Pennzoil Producing has no quarrel with this reading of *Mobil.* But surely if relief on some

grounds is possible, the Commission must have authority to determine whether the grounds warranting such relief are present, and, if so, to grant the relief.

In its Petition, the Commission again attempts to deal with this Court's holding in *Mobil* that ". . . an affected producer is entitled to seek individualized relief . . . ." The Commission suggests that this holding was a recognition of the Commission's general authority to grant relief in some cases where actual costs exceed those provided for in the ceiling rate, but was not a recognition of the Commission's authority to grant such relief if the costs involved are royalty costs based on prices in excess of ceiling rates.[7] In fact, of course, this Court's holding in *Mobil* was not simply a general statement made without reference to a particular issue. Rather, as discussed above, the Court was responding specifically to the problem posed by royalty costs based on prices in excess of ceiling rates. This is made clear by the Commission's brief to this Court in the *Mobil* case. At page 62 of that brief, the Commission evidenced full confidence in its authority to permit the relief sought by Pennzoil Producing:

> "Mobil argues . . . that the Commission improperly treated royalty payments as a fixed percentage of total costs, because some producers *may* be required to pay royalties on the basis of higher values. *The court of appeals correctly concluded that* the issue is hypothetical at this stage and that *if it becomes a reality producers may seek special relief from the Commission.*" (First emphasis in original; other emphasis added.)

The Commission is now in the position of arguing that its area rates are appropriate because if a producer is faced with a higher royalty cost that producer may seek individualized relief but the catch is the Commission lacks authority to grant such relief. This in itself demonstrates the lack

[7] Pet. 15.

of basis, and reason, underlying the Commission's petition for a writ of certiorari — such a result is absurd.

Despite the clear holding of *Mobil* affirming the Commission's authority in this case, the Commission asserts that the decision by the Court below is inconsistent with *FPC* v. *Texaco, supra.* The Commission contends that it is precluded from granting the price increase request because *Texaco* denies the Commission authority to deem a price just and reasonable solely by reference to market price.

The Commission's reliance on *Texaco* is misplaced for two reasons. First, *Texaco's* proscription against basing a just and reasonable finding solely on the fact that the price involved is equal to market price has no application to this case because the price increase involved here is not based on market price at all. As the Commission suggests,[8] market price as used in *Texaco* means the price obtained in a non-regulated market.[9] Thus, in Southern Louisiana the only prices that can possibly be classified as market prices in the *Texaco* sense are those for intrastate sales. While Williams' claim is certainly based on such intrastate prices, the royalty cost under the settlement agreement upon which the price increase request is based most assuredly is not. Rather, the royalty basis is a compromise figure substantially less than the intrastate prices which form the basis for Williams' claim. The price increase in fact is based on and tied to Commission approved ceiling rates. The Commission's statement that this case involves a price increase based on market prices is contrary to the facts.

But even if the price increase were based on market price as that phrase is used in *Texaco,* the Court's holding below would still be entirely consistent with *Texaco.* The Com-

[8] Pet. 12.

[9] Of course, in our view market price in a regulated market is the price one is permitted by the regulator to receive. Thus, "market rate" as used in the Williams lease means the prices permitted by the Commission since the Williams acreage gas is sold in a regulated market.

mission's position to the contrary is based on the erroneous premise that *Texaco* precludes the Commission from considering any facts bearing on justness and reasonableness if the price under consideration happens to coincide with market price. In fact, *Texaco* does just the opposite. It requires the Commission to consider all relevant facts bearing on justness and reasonableness by precluding the Commission from relying *solely* on the fact that a price coincides with market price.

In short, *Texaco* is simply an affirmation of the inherently factual inquiry that must be made under Section 4(a) of the Gas Act. The Commission cannot approve a rate simply because it coincides with market price. Rather, all relevant facts must be considered. By the same token, the Commission cannot reject a price simply because it coincides with market price. Again, all relevant facts must be considered.[10]

As recognized in *Texaco,* there may be any number of facts which may support a finding of justness and reasonableness.[11] For example, a rate may contain a non-cost component designed to encourage exploration and development, *Mobil Oil Corp.* v. *FPC, supra,* at 320. Moreover, even while holding that justness and reasonableness cannot be satisfied solely by reference to market price, this Court in *Texaco* made clear that market price "may certainly be taken into account along with other factors."[12] Indeed, the Commission itself has recently recognized its authority to consider intrastate rates in determining just and reasonable prices and has determined it is "imperative to correlate intrastate sales to interstate rate making . . . ."[13] Further,

[10] *Texaco* was decided by this Court on the *same day* that *Mobil* was decided. Thus, adoption of the Commission's view would lead to the untenable conclusion that this Court denied by implication in *Texaco* the very same authority it simultaneously and expressly upheld in *Mobil*. Clearly, the Commission has misapprehended the *Texaco* holding.

[11] *FPC* v. *Texaco,* 417 U.S. 380, 397 (1974).

[12] *Id.*, at 399.

[13] *Continental Oil Co.* v. *FPC*, 519 F.2d 31, 34 (5th Cir. 1975).

as in this case, a price may be based on costs. As the Court below held, whether the price increase is just and reasonable under such circumstances depends upon the prudence of those costs. The Commission has the authority and responsibility under Section 4(a) of the Gas Act to consider the relevant facts and permit the price increase if the facts show it to be just and reasonable. Both *Mobil* and *Texaco* confirm that authority.

II.

POSSESSION OF AUTHORITY ENHANCES RATHER THAN UNDERMINES THE COMMISSION'S ABILITY TO PERFORM ITS DUTIES

Curiously, the Commission asserts that possessing authority to permit increased royalty costs to be included in producer rates if those costs meet the statutory test will undermine its ability to perform its statutory duties (Pet. 9, 15). That assertion necessarily ignores the scope of the Commission's duty under the Gas Act.

It is well-settled that the Commission's ultimate function is to assure an adequate supply of gas to interstate consumers at the lowest reasonable rate and that the rates set under Section 4 of the Gas Act must be just and reasonable to both the consumer and the seller.[14] In order to accomplish that overriding objective, the Commission is obligated to consider fully the effects of its actions and to consider the myriad of factors bearing upon the end result and upon the rates it sets.

The myriad of considerations in any particular case may demonstrate that permitting a producer to recover an incremental royalty cost would indeed accomplish the objectives established by the Gas Act and that a refusal to so permit would be destructive of those objectives. Nevertheless,

[14] *Mobil Oil Corp.* v. *FPC*, 417 U.S. 283, 321 (1974); *Permian Basin Area Rate Cases,* 390 U.S. 747, 776, 793 (1968).

under its restrictive view of its authority, the Commission would be unable to permit the more desired result *regardless of the facts or probable end result of its action* if the royalty increment exceeded the royalty component of its previously-established rates. On the other hand, if the Commission does have the necessary authority it will be in a position to weigh all the factors involved and make a rational decision one way or the other on the merits. We fail to perceive how the Commission's having the ability to consider all factors and decide a case on the merits will undercut its ability to carry out its mandate under the Gas Act, and the Commission has not set forth any reasons supporting its statement. Under these circumstances, there is no reason to issue a writ of certiorari because there is no possibility of a result which would impair the Commission's fulfillment of its duties.

The Commission attempts to distract one's attention from this situation by suggesting that this Court can solve all problems arising from royalty litigation by either (1) "reshaping" *Mobil Oil Corp.* v. *FPC,* 463 F.2d 256 (D.C. Cir. 1971), *cert. denied,* 406 U.S. 976 (1972), which held that royalty owners/lessors are not subject to the Gas Act (Pet. 17) or (2) holding that "market value" leases do not require royalty payments based on rates in excess of Commission ceilings (Pet. 18).

Of course, neither alternative is required if the Commission has authority to address the merits of the price increase request as we believe it does. More significantly, however, the issues which would have to be addressed in attempting either alternative are not in this case. First, the question of jurisdiction over royalty owners has been resolved adversely to the Commission, and certiorari was denied. The Commission's statement that the Court need not hold royalty owners "fully" jurisdictional, but only partly so, demonstrates the thinness of that straw. Second, the issue of what "market value" leases require in the way of royalty payments was not litigated in this case and is not

at issue — it is still pending as an issue in the litigation which Pennzoil's settlement seeks to terminate. Consequently, neither of those "issues" can serve as justification of, or as showing a need for, a writ of certiorari in this case.

III.

THE COMMISSION'S AUTHORITY TO GRANT THE PRICE INCREASE REQUEST IS THE ONLY ISSUE POSED BY THIS CASE

The Commission asserts this case poses the question whether the Commission has the authority to grant the abandonment request. The Commission's authority to grant the abandonment, however, is clearly set forth in Section 7(b) of the Act, 15 U.S.C. § 717f(b), which, as pertinent here, authorizes the Commission to allow abandonment if "the present or future public convenience or necessity permit. . . ." The clear language of the Act precludes any serious question as to whether the Commission has the authority to determine whether the abandonment requested by Pennzoil Producing is or is not permitted by the public convenience or necessity. And, in fact, no such question is presented because *the Commission in Opinion No. 753 did not deny its authority* to assess the abandonment alternative on the merits. Rather, the Commission exercised that authority and denied the request based on its assessment that the facts did not justify abandonment.

The Court below merely determined that the abandonment request must be reconsidered because the Commission failed to consider the possibility of the interstate market losing all of the gas in the event of lease termination. The Commission's authority to grant the request if

deemed justified was never in issue either at the Commission level or before the court below.[15] It therefore is not an issue presented by this case.[16]

CONCLUSION

For the foregoing reasons Pennzoil Producing submits that the petition for a writ of certiorari should be denied.

Respectfully submitted,

A. DUNCAN GRAY, JR.
Vice President and
General Attorney
Pennzoil Producing Company
3100 Pennzoil Place
Houston, Texas 77001

JERON STEVENS
STEPHEN M. HACKERMAN
Baker & Botts
3000 One Shell Plaza
Houston, Texas 77002
(713) 229-1234

Counsel For Respondent
Pennzoil Producing Company

[15] The Commission apparently recognizes the fact, for it admits (Pet. 15, 16) that in Opinion 753 it denied abandonment because of its finding that the abandonment request did not meet the statutory test.

[16] *See Burlington Truck Lines, Inc.* v. *U.S.*, 371 U.S. 156, 168-9 (1962); *SEC* v. *Chenery Corp.*, 332 U.S. 194, 196 (1947).

CERTIFICATE OF SERVICE

I hereby certify that I have served three copies of Pennzoil Producing Company's Brief In Opposition on counsel of record for the other parties by depositing copies of it in the United States Mail, postage prepaid, on December 2, 1977.

JERON STEVENS